DOW THEORY LETTERS INC.

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EXTRAORDINARY BEARISHNESS: In Letter 652 I wrote that "there are two phenomena which I always watch for: (1) a new all-time record for an indicator, and (2) a very persistent trend in the Averages or an indicator."

At that time I pointed out that odd-lot selling ratios (monthly data) were at the highest level in 56 years. The public, in a phrase, was selling their heads off. That selling proved to be even more persistent and impressive than I had imagined. After the normal reinvestment period of the first few weeks of 1976, odd-lot selling has now increased again. Hardly a day goes by when sellers do not outnumber buyers 2 to 1. Thus, the public is still bailing out of this primary bull market as stocks push higher. This is a very bullish situation.

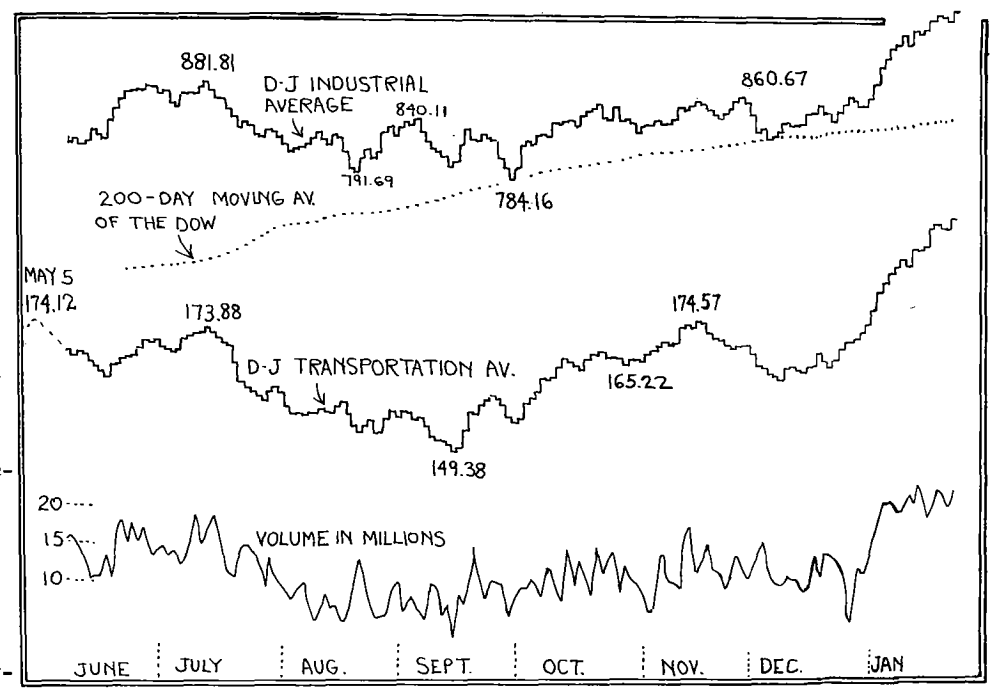
Next, on January 21 the NYSE released the news that the total short interest on the NYSE had jumped 1.5 million shares to a record 27.1 million shares sold short (as of January 15). This too, has to be taken as a highly bullish factor. I've written this before, but I want to say it again. A high and rising short interest within a primary bull market creates a very explosive situation, not merely because the shorts must eventually cover, but because the high short interest is an expression of disbelief in the primary bull trend.

As measured by the short interest, we now have the highest level of disbelief ever to be recorded within a confirmed bull market. I would take this to mean that Wall Street, the public, the traders, what-have-you, are far too conservative or pessimistic regarding where this bull market is headed. I believe the record short interest is telling us that in no uncertain terms.

Look at these figures. General Motors' short interest up 30% for the month to 224 thousand. US Steel's short interest up 37% for the month to 201 thousand. General Food's short interest up 66% for the month to 78 thousand. Exxon's short interest up 54% to 73 thousand. Texaco's short interest up 918% to 77 thousand! These are not arbitrage shorts, these are regular shorts in leading stocks in the Dow Industrials. I can only say (1) that the figures are extraordinary, (2) that the skepticism regarding this bull market as it moves into its second phase is amazing, and (3) that sights should now be raised regarding how far this second phase of the bull market could carry before its full potential is spent.

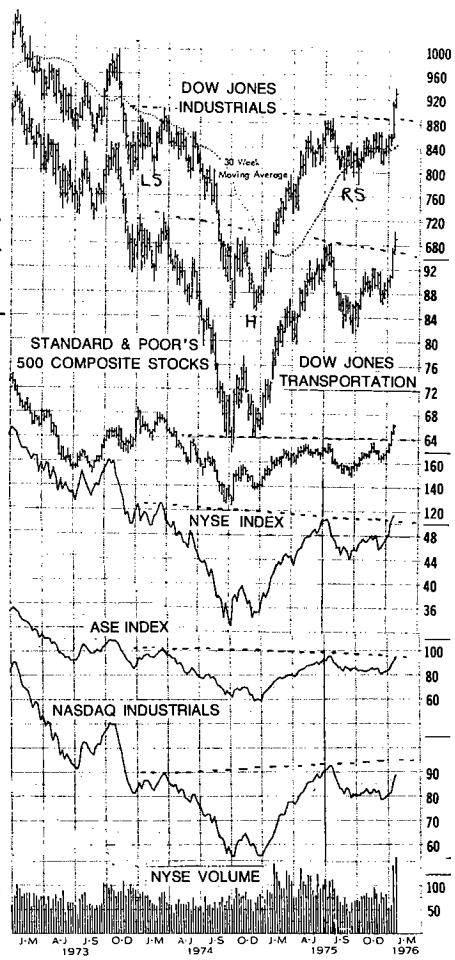
THE MARKET: I am tempted to label the January, 1976 stock market action as "The Explosion of the Head-and-Shoulders bottoms." Never, in all the years that I have been watching the market, have I seen so many of the powerful head-and-shoulders bottom patterns in the various indicators. And the fact is that virtually all of these patterns broke out on the upside during the first few weeks of 1976.

The H & S bottom formation was described on page 4 of the last Letter. Basically, this pattern is one that denotes accumulation during three successive declines. The first decline forms the left shoulder, and here volume is usually heaviest. The deepest decline forms the head, and here volume recedes. The third decline occurs on the lightest volume of all, and the tendency is for the right shoulder to correspond in width and depth to the left shoulder. Why this kind of symmetry should appear so often in market movements has never been adequately explained. But as a rule, the more perfect the symmetry, the more reliable and powerful the pattern.



As a point of interest, I am including a composite chart (page 2) showing six average and indices (plotted

weekly) tracing market action from 1973 to date. In each of these indices we see the extraordinary head-and-shoulders bottoms patterns which have lent such power and violence to the final 1976 breakouts. For reference purposes, I have marked the Dow Industrials with an LS (left shoulder), H (head) and RS (right shoulder), and these same designations apply to the other five indices on this chart (chart courtesy CMI, PO Box 1557, Bellevue, WA 98009).



GROUPS: For many years I have run studies of stock group action. My experience indicates that there is no stronger bull market than one in which there is broad group participation on the upside. It is one thing to have a spotty or selective market, a market in which a few strong stocks in each group serve to mask a basically weak or narrow market. But when an increasing number of stock groups turn bullish, we have a situation which is saying, "This is broad, fundamental strength, strength not concentrated in the best few stocks in each group but strength throughout many groups."

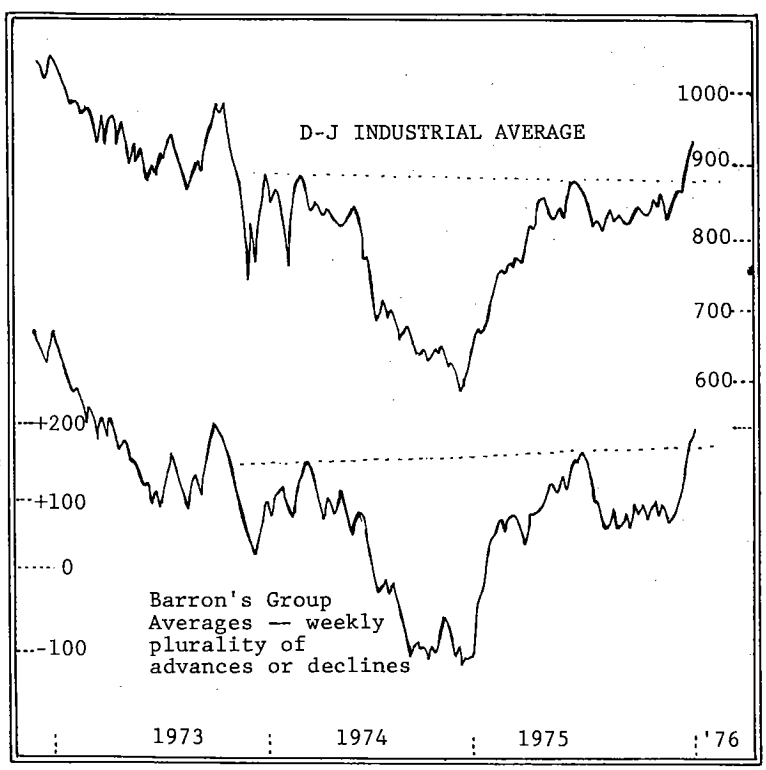
Whatever factors lend strength to a stock group also provide a bullish bias to almost all the stocks in that group. And when group after group join the upside parade, we have the foundation for a powerful, long-lasting bull market. That, it appears to me, is what the group studies are telling us today.

How does one check for group participation in the stock market? One method I use is an advance-decline line of the plurality of the 34 Barron's Stock Groups. It works this way: each week Barron's publishes a listing of 35 major stock groups (I delete the Gold group because it tends to be contra-cyclical). Barron's shows the weekly percentage of advance or decline for each individual group. I tabulate the plurality of groups advancing or declining for the week, and this weekly plurality is added to (or subtracted from) a running total. The new total is charted along with the Dow closing for the week, and this is the basis for the chart which is shown in this study.

The first thing we note on the chart is (again) the extraordinary head-and-shoulders bottom in the group A-D line. Note also the powerful breakout which occurred on the week ending January 16, 1976. With that breakout, the group A-D line advanced to its highest level in two years.

The conclusion implied by this study is clear. Group strength and upside participation in this bull market is very strong indeed, and the power of the 1976 upthrust should carry forward for some time. The tremendous 1976 breakout on the group chart contains a bullish message not only for the various groups, not only for the stocks within those groups, but for the US economy as well (since the economy is amply reflected in the action of these 34 different groups).

NEAR-TERM MARKET: There is no way of telling how far a primary market swing will carry. We can get hints, we can formulate technical projections, we can come up with educated guesses. But in the end I prefer to stick to that safest of all market adages, the one that states that "Neither the extent nor the duration of a primary movement can be predicted in advance." A primary movement is a law unto itself, and primary advances and declines tend to end in only one way — exhaustion. A primary bull advance ends when the last optimist has spent his money; a primary bear decline ends when the last pessimist has swapped his stock certificate for cash.



There are a few things that we can say about primary swings, however, and I might as well get them down in black and white now. As a rule, the more forceful the initial breakout from the base, the more powerful the ensuing move. Based on this thesis, the current Wall Street advance could be of historic proportions before it reaches the final exhaustion stage.

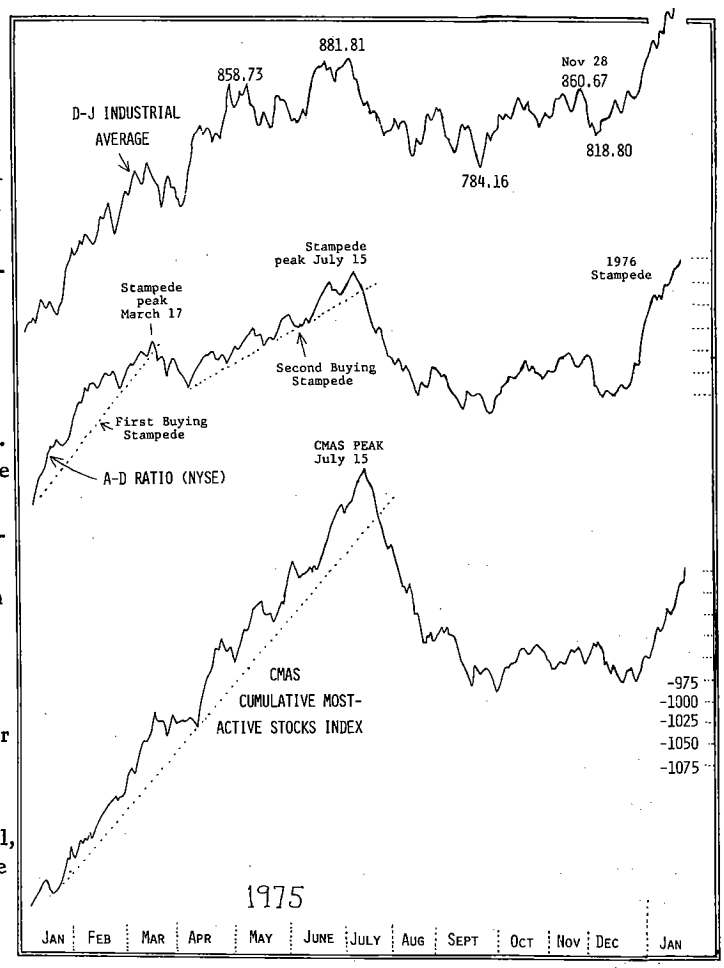
During the first two weeks of January we have seen all three Dow Averages push to bull market highs. We have seen the rest of the major Averages and Indices (NYSE, S & P, etc.) follow to new bull market highs. On January 8 the Negative Volume index rendered a very bullish signal. On the same day my Primary Trend Index broke above its July 15 peak to reach a new bull market high. On January

14 the A-D ratio signalled a "buying stampede" by rising over 5 points from its December low (without so much as a 1 point intervening correction). On January 19 the A-D ratio confirmed the Dow by pushing above its July, 1975 high, thereby rising to a new bull market recovery high.

Volume on the NYSE during this extraordinary string of technical breakthroughs was of record proportions with day after day in the 25 to 38 million share class. Thus, not only did the technical breakouts (upside penetrations) include a broad spectrum of averages and indices, but the force of the penetrations (volume) was awesome and undeniable.

What could happen next? It is possible that the character of this market will remain much the same during the various upward swings. If so, we do have some hints as to what could lie ahead. From December, 1974 to March, 1975 the Dow Industrial Average advanced for 63 trading sessions before even minor trouble appeared. By "minor trouble" I mean a decline which took the Industrials below a preceding minor low. This type of minor trouble did occur during March and April, 1975, following which the market took off on the upside again.

The Dow finally topped out in a secondary sense on July 14. In retrospect, we can say that the Dow pushed up from its December 6, 1974 low of 577.60 to its July 14, 1975 peak of 881.81 over a period of 151 trading days before topping out in a secondary sense.



If we take the 1976 advance as having started from the October 1, 1975 low of 784.16 on the Dow, then approximately 90 days have now elapsed since the bottom. Aside from minor one or two week declines, this rise could easily match that of 1975 — and there is no law that says it could not better the 1975 effort. As yet, there is nothing in the technical situation to suggest that the 1976 buying stampede has ended. The odd lot public remains bearish and heavily on the sell side, the daily new highs are coming through in excellent fashion, the strength is spreading out to other-than-Dow issues, and all the technical indicators remain in gear on the upside.

Furthermore, I should make these observations: record volume almost never coincides with the top of a movement. And the termination of a buying stampede (and we are now in one) seldom coincides with the end of a rise.

POTENTIAL: When a movement begins during a bull or bear market, there is always a bullish or bearish "potential." Many analysts have attempted to measure this potential in advance. For instance, in the last report I used the "head-and-shoulders pattern" concept to measure the upside potential for this rise, and my conclusion was that the head-and-shoulders bottom pattern in the Dow allowed for a potential of 1200 or more.

Some analysts use point-and-figure charts with upside and downside "counts" in an attempt to figure the potential of a movement (I often use this concept myself). Edson Gould, the famous East Coast advisor, has developed his speed-resistence lines, and these often provide approximate targets or upside and downside potentials for a move. Those who have read the Edwards and Magee book, "Technical Analysis of Stock Trends," know that many of the technical patterns are discussed together with their projected counts, patterns such as rectangles, ascending triangles, flags, etc.

As a rule, one should think in terms of an upside potential being surpassed during advances in a bull market, while in bear markets it is generally good policy to think in terms of the downside potential being surpassed. Furthermore, a build-up in the technical position of the market during a bull market consolidation will usually insure that the upside potential will be met or surpassed (the converse is true in a bear market).

In the last report I discussed the three (psychological) phases of a bull market, and I noted that we are now in the second phase. This is the phase in which the market rises as it discounts gradually improving conditions, economic, social and political, conditions which will exert a favorable influence on corporate equities.

It was during the second phase of the 1949-66 primary bull market that we witnessed the amazing and almost uninterrupted three-year advance of 1953-56. Here the Dow rose from the 1953 low of 255 to the 1956 peak of 520 before the first real trouble appeared. Although no two bull markets are exactly alike, I have been wondering whether we may not now get some sort of repeat of the 1949-66 second phase (as per 1953-56).

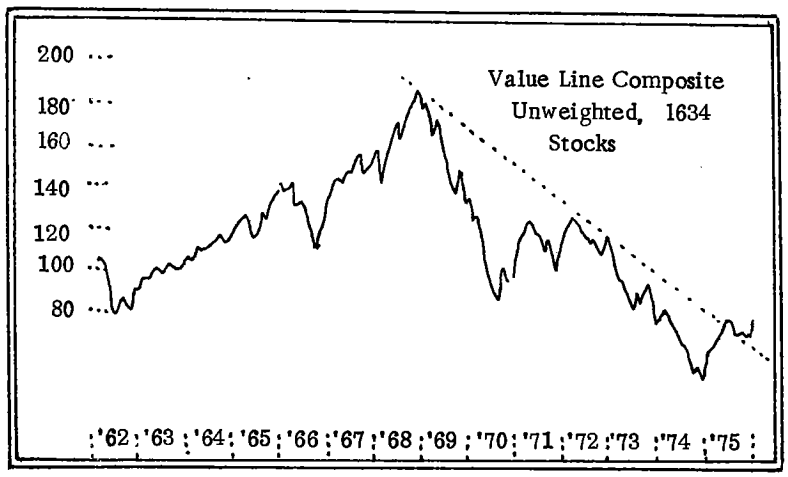
There is a very logical reason why second phase advances in a primary bull market can be spectacular. In the first phase the bull market is bouncing off the preceding bear market bottom as it did during 1949 to 1953 and as it did during late 1974 and the first half of 1975. During those first phase recoveries suspicions are rampant, basiness is still depressed, losses are still horrendous and there is almost a consensus that the first phase advance is "just a rally in a bear market."

It is during the second phase of a bull market that the professionals become believers. The second phase breakout above the preceding first phase highs (such as occurred during February, 1954 and January, 1976) serves to convince even hard-nosed bears that "this really is a primary bull market."

It is also during the second phase that the bears seem to get that final "coup de grace." In 1954 it occurred this way: after pushing to new bull market highs in early 1954 the Dow in November, 1954 broke above the old 1929 high of 381. This movement electrified Wall Street, it was something that the Dow had failed to achieve on every rise of the past 25 years! If anyone in November, 1954 still doubted that it was a bull market, they had no business wasting their time and money in the securities business.

By the same token, I am wondering whether this 1976 bull market won't give the bears a current version of 1954's "zonk on the head." It would not surprise me to see the Dow, here in 1976, push above the 1973 record Dow high of 1051. If that occurs it would certainly get headlines for the stock market, and it would be Wall Street's way of announcing to Main Street and the world that this is indeed "a full fledged roaring bull market."

MORE ON POTENTIAL: The Value Line Index is an unweighted index of 1634 stocks listed on the NYSE. I used this Index in December, 1974, as a guide in demonstrating just how crushing the decline from the 1968 highs had been. At that time I wrote that the unweighted Value Line Index (which would be typical of the action of the average stock portfolio) had lost about 75% of its value.



From its December 1974 low of 48, the Value Line Index has now moved into the 78 range. It is important to realize that the halfway point of the entire 1968 to 1974 collapse in the Value Line Index comes in at about 121. This means that the Value Line Index would have to rise almost 50% from current levels just to recoup half of its 1968-72 losses.

It is almost unprecedented for a bull market to fail to recover at least half of the losses of the preceding bear market (even as measured on an unweighted average). Therefore, I would say that the odds very definitely favor the Value Line Composite Average ultimately moving up to at least the 121 level, a level which would mean substantial gains for the average NYSE issue, regardless of any intervening corrections, declines and rough spots.

Conclusion: If past precedent means anything, the potential on the upside for this bull market is still excellent. It is possible, in view of the far greater collapse (during 1968-74) of the unweighted averages, that the great upside potential lies with the average NYSE issue rather than the widely followed Dow Industrial stocks. This is the reason I continue to recommend (see last Letter) lower-grade issues (around $10 or less in price) which, if my studies of history mean anything, could provide substantial profits to holders over the period ahead.

Now for this week's word of caution: I want to remind subscribers that all market movements, whether minor, secondary, or primary, are ultimately corrected (usually a one-third to two-thirds correction in the opposite direction). This rise will be no exception. The character of the ultimate correction is usually directly connected to the character of the rise (violent advances breed violent corrections, and dull rises breed dull corrections).

But with a current huge short interest on the NYSE, with fantastically heavy and continuing odd-lot selling, with breadth (the A-D ratio) beginning to outperform the Dow, it might not be bad policy to expect "the unexpected." What would constitute the unexpected at this time? Based on the explosive force of the January technical breakouts, the unexpected just might be a rise of totally unexpected proportions. Mind you, I am not saying that it will happen or that it has to happen, I'm just saying that a continuation of this advance would leave Wall Street and the nation with its lower jaw hanging limply — and that just might be what's in the cards.

MANIPULATION: Whenever the market becomes difficult or fails to live up to "expectations," the cry of manipulation fills the air. Thus, this writer was held at least partly responsible for the market crack of December 3 (due to a mention in the Wall Street Journal). In the December 15 issue of Barron's Richard Ney's new book about Wall Street is reviewed, and of course Mr. Ney's main contention as usual is that the specialists are rigging the market. Others consistently blame Mr. Burns or the Fed for their market problems, and still others insist that "the interests" are running the market (Lord knows who the

interests are; I've never quite been able to uncover them).

Manipulation on even a minor scale is rare on Wall Street. Occasionally we hear about an individual issue (usually a narrowly held company) which has been fraudulently manipulated, but in my opinion manipulation of the trend of the market is rare on an intra-day basis, almost unheard of on a secondary basis and absolutely impossible in the primary sense.

There isn't enough money in the US Treasury, the "Big Four" of Switzerland and all the Arab coffers to turn a primary bear market bullish. And all the statesmen in the Free World turning bearish together couldn't turn a primary bull market to the bear side. On the contrary, a contra-trend event merely serves to strengthen the prevailing primary trend. A panic during a bull market simply wipes out a lot of amateur money, while an optimistic word from the President during a bear market may set off a one-day rally, but the net effect is losses on the part of a crowd of misguided buyers.

In a secondary sense, an occasional news event of earth-shaking importance (such as the Korean War or the Eisenhower heart attack) can temporarily knock a market to its knees, but if the tide is bullish the effect is a blip on the charts and a footnote in the annals of Wall Street.

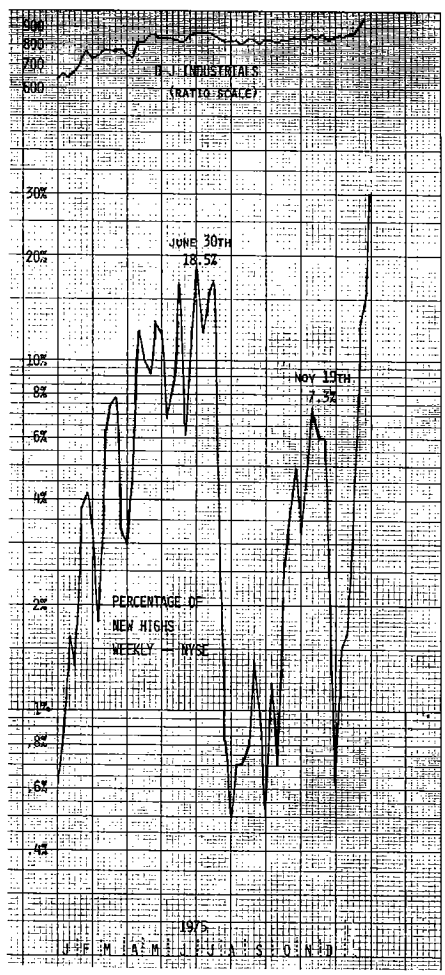
COMPOUNDING YOUR MONEY: In Letter 651, page 5, I commented that for those who have assets of over $100,000, it would probably be a good idea to cease thinking about speculating. What one should think about, I stated, is compounding your money at today's fantastic interest rates.

I received two irate letters from readers stating that with "today's taxes" there is no way to make money by compounding. It's all taxed away each year, these readers pointed out, so why bend their ears about the wonders of compounding money?

My answer to these readers is that the times have changed! If you have a corporation, the Government gives you the best deal in the land. That bonanza is the corporate profit-sharing and the corporate pension plan. If you own a corporation and have not got these two plans, get over to your accountant and lawyer as quickly as you can and find out about them. These plans offer you the opportunity to take 25% of salaries before expenses and put that money into these plans with no taxes until you pull out of the plan.

Individuals can compound their money via Keogh plans or deferred annuity plans. I'll say it again to all my subscribers: Investigate pension, profit sharing, and deferred income plans. They allow you to compound your money at the highest interest rate levels since the Civil War. Why more investors and corporations can't understand this I'll be damned if I know. But my advice is — get with it. It's a real gift (and one of the few) from your Uncle Sam.

TECHNICAL NOTES: The weekly cumulative most active stock index read plus 42 (out of a possible 60) for the three weeks ending January 23. This is very powerful action. The negative volume index is now undergoing one of its strongest advances in years. The percentage of all NYSE issues traded which made new highs for the week (week ending Jan. 23) hit 31%, far above the previous June peak (see chart). This is an update of the study presented in Letter 651, page 4.



STOCKS: In the last Letter I recommended a number of lower priced stocks, stocks which I felt constituted a "call" on this primary bull market in that they were the kind of issues that could potentially double and triple as the public finally entered the market.

I want to make this point. We are now in the second psychological phase of the bull market, according to my studies. This is still basically an accumulation phase (as opposed to the third speculative phase, which is a distribution phase). Many of the low priced stocks started moving up over the past week or so (the timing of my last Letter was probably coincidental with this action, since I hardly think I am capable of moving markets).

But if this continues (and I think it will) we can expect to hear people saying, "See, the junk is moving, and that means that we're in the final throes of the rise!" These people will be wrong, in my opinion. This is not the final phase, the public is still selling on balance (according to odd lot studies), mutual funds are hardly pulling any big money on balance yet, and the current stock market is now going up on what the professionals know, not what the crowd thinks. Therefore, I see this as accumulation time for the undervalued secondary issues, the less-than-blue chip stocks, the low-priced issues, the overlooked issues.

If this bull market conforms to bull markets of the past, before it is over every stock group and most stocks will have had their fling on the upside. That is why the lower priced stocks should be bought and put away now. And it should be remembered that heavy accumulation does exert some upside pressure on stocks (and we can see it happening in the list which was published in the last report), but this early upward push

is not the real bull market story. That story will be told when the economy turns dramatically better and when the public is reading about the upturn in the newspapers and buying stocks on the basis of the news.

Before going into additional individual stocks, I want to say something about the closed-end stock funds. These issues are still way behind the market. They are probably behind because the institutions do not buy them, the public does, and the public has not admitted that we're in a bull market yet. Tri-Continental is selling at a discount from net asset value of around 20%, Madison Fund is about 30% under net asset value, US and Foreign Securities is 19% under market value. The discount from net assets (and, of course, assets are rising) should narrow considerably as the bull continues, and I see nothing wrong with buying these shares at today's large discounts.

There has been so much interest in the low-priced selections of the last Letter that I want to add a number of other issues to the list. I have screened these shares carefully, and I feel that a package of them should do very well before this bull market breathes its last. Many of the following stocks are still 70% to 90% under their former highs, all are around $10 or below, all are listed on the NYSE, most are on the recovery path from difficult times experienced over the past few years.

Here they are, and again I say, (1) do some research on them yourself or get your broker to do some work (he should be wide awake and ready to go at this juncture), (2) do not pick just one or two issues. Try to buy 7 to 10 selections so that the bull can work for you. Allis-Chalmers, Avco, Addressograph (I'm repeating this one because I particularly like it, but I also like all the issues in the last report), City Investing, Clorox, Evans Products, Coastal States Gas, Fedders Corp, Fuqua Indust., Far West Financial, Handelman, Monroe Auto Equip., Reliable Stores, Seaboard World Airlines, US Leasing, Telex, Saxon Industries, Zayre Corp.

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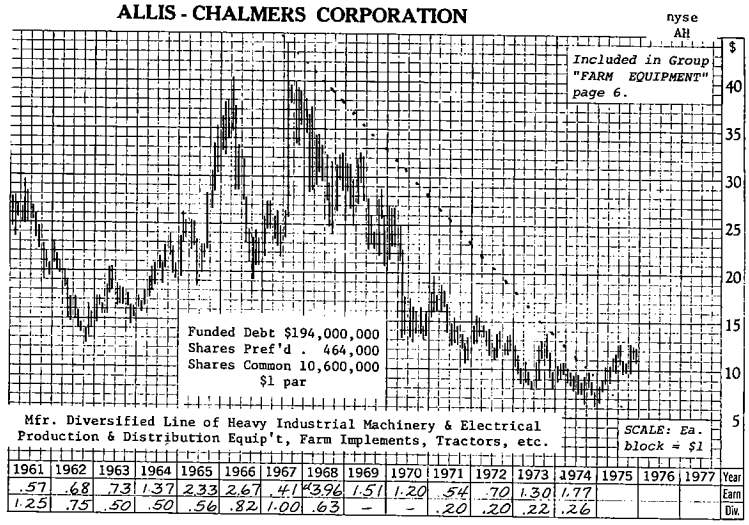

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	
Year	.57	.68	.73	1.37	2.33	2.67	.41	*3.96	1.51	1.20	.54	.70	1.30	1.77				
Earn	1.25	.75	.50	.50	.56	.82	1.00	.63	–	–	.20	.20	.22	.26				
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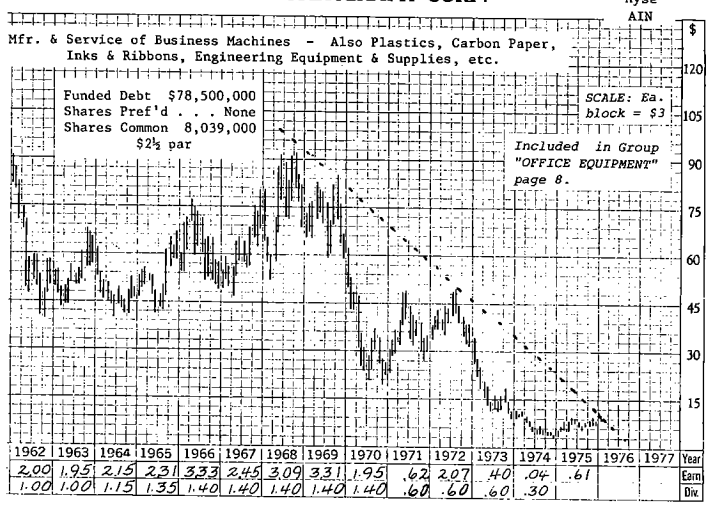
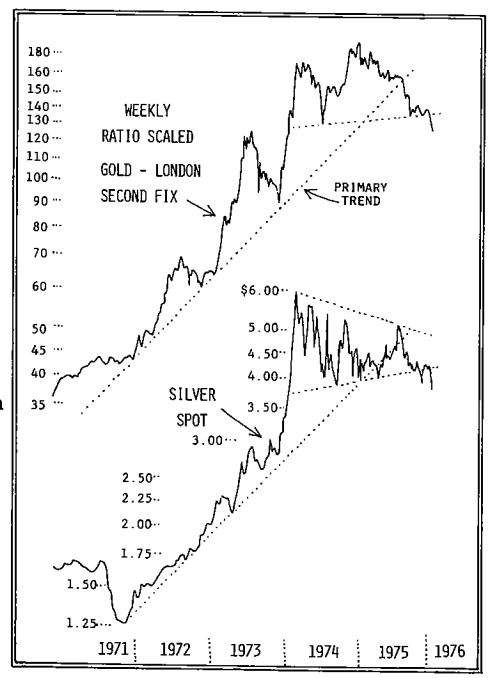


	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	
Year	2.00	1.95	2.15	2.31	3.33	2.45	3.09	3.31	1.95	.62	2.07	.40	.04	.61			
Earn	1.00	1.00	1.15	1.35	1.40	1.40	1.40	1.40	1.40	.60	.60	.60	.30				
Div.																	

I wish I had room to illustrate all these issues (with charts) but I am including two long-term monthly charts to show what a completed bear market (completed in my opinion) looks like. The upside potential or a bounce even halfway back to the old highs is obvious enough. (Charts courtesy of Horsey, Salisbury MD 21801).



GOLD & SILVER: Gold broke below 126 on Jan. 26. As seen on the chart, gold has now broken its support, and the massive head-and-shoulders top pattern appears to be breaking down. Silver is following gold's weak lead. For the time being, US dollars and US stocks are the desired repositories of wealth. It will probably change one of these days — but for now the bear market in gold continues (Note: when Italy closed its foreign exchange window, gold remained dull but the dollar spurted!).

NOTICE: The new 1975 pages are now ready for all those who wish to add them to their daily advance-decline ratio chart books. The 1975 page shows the explosive "buying stampedes" of early 1975 and the later effects of the NYC default-crisis on the market. Please send $2 for the 1975 daily A-D ratio charts (Daily Dow Industrials on same page). A second blank sheet of the chart paper will be sent with each order. (Note: these pages will be mailed folded in regular #10 envelopes in an attempt to make it easy on us and to keep the costs down).

WISE WORDS: Says friend Edson Gould in his Jan. 21 report, "In a bull market one should look for an expect buying opportunities — not selling opportunities. The successful investor must exercise patience and restraint — and that's not easy. Patience to wait out the moves in the direction of the trend. Restraint, to avoid trading contrary to those moves." Next mailing: February 6th.